No. 85-2006

In the Supreme Court of the United States

OCTOBER TERM, 1986

NATIONAL CAN CORPORATION, *et al.*,

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellee.

On Appeal from the Supreme Court of Washington

APPELLANTS' REPLY BRIEF

JOHN T. PIPER*
D. MICHAEL YOUNG
FRANKLIN G. DINCES

BOGLE & GATES
2000 Bank of California Center
Seattle, Washington 98164
(206) 682-5151

Counsel for Appellants

*Counsel of Record

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or call collect (402) 342-2831

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1. **Washington's Taxes Favor Local Business.** The State, acknowledging that it "may not provide a direct

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[1]Pursuant to Rule 28.1, Appellants state that the only changes to their original Designation of Corporate Relationships, App. G to J.S., as amended by footnote 1 to the Brief in Opposition to Motion to Dismiss or Affirm and the Appendix to the Brief for Appellants are: The British Columbia Sugar Refining Company, Ltd., is now a parent, and Chatteron, Inc., is now an affiliate, of Appellant Kalama Chemical, Inc.

commercial advantage to local business,'"[2] theorizes that the prohibition is rigidly confined to just two mechanisms: those that either (a) "erect barriers," or (b) "allow an interstate business, already subject to a state's taxes, to *reduce* its tax burden in the state by *increasing* its business operations there." Appellee's Br. 15 (emphasis in original). The State errs in assuming that every other kind of direct commercial advantage somehow fosters "tax neutral decision-making." *Id.* But even if the prohibited "direct commercial advantage to local business" were as narrowly confined as the State theorizes (which we dispute *infra*), Washington's taxes provide just that kind of impermissible advantage.

a. **Reducing Washington Tax by Increasing In-State Business.** Companies can reduce their Washington taxes by increasing their in-state business activities as the following examples illustrate:

Example: Company X manufactures $50 million of paperboard in Washington, ships it to Oregon, and there converts it into boxes, adding $20 million of value. X then sells the finished product to Washington customers for $70 million. X's Washington tax liability is approximately $572,000—*i.e.,* $242,000 of manufacturing tax (0.484%[3] x $50 million manufacturing activity) plus $330,000 of whole-

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[2]Appellee's Br. 15, *quoting Boston Stock Exchange v. State Tax Commissioner,* 429 U.S. 318, 329 (1977).

[3]Wash. Rev. Code §§ 82.04.240 & 82.04.2904. (The Washington statutes cited herein are reproduced in Appendix E of National Can's Jurisdictional Statement.)

saling tax (0.484%[4] x $70 million in-state selling activity). X is also subject to an apportioned Oregon tax (on its conversion of paperboard boxes in Oregon). If X shifted its Oregon manufacturing activities to Washington, all of its manufacturing activities would become exempt from Washington tax.[5] By *increasing* its Washington activity, therefore, X would *decrease* its Washington taxes from $572,000 to $330,000 (as well as eliminating the tax paid to Oregon). *See Fibreboard Paper Products Corp. v. State,* 66 Wash. 2d 87, 401 P.2d 623 (1965).

Example: Company Y manufactures $30 million of products in Washington that it retails in other states. It pays approximately $145,200 in Washington manufacturing taxes (0.484% x $30 million of products). If Y doubled its Washington activity to $60 million by shifting all of its $30 million of retailing activity from other states into Washington (to combine with its $30 million of manufacturing activity), it would become exempt from Washington manufacturing tax.[6] It would pay approximately $141,300 tax on retailing its $30 million of products in Washington (retailing tax rate of 0.471%[7] x $30 million tax base). By *increasing* its Washington activity, Y would *reduce* its Washington tax burden (as well as eliminate taxes paid to other states on the selling activities performed there).

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[4]Wash. Rev. Code §§ 82.04.270 & 82.04.2904.

[5]Wash. Rev. Code § 82.04.440.

[6]*Id.*

[7]Wash. Rev. Code §§ 82.04.250, 82.04.2901 & 82.02.030.

Example: Company Z wholesales $50 million of products in Washington that it manufactures in other states. It has a Washington tax burden of $242,000 (0.484% wholesaling rate x $50 million of products sold in Washington). If Z shifted $40 million worth of its manufacturing activity to Washington and wholesaled the same $40 million worth of product there, it could increase its business activity in Washington from $50 to $80 million, while *reducing* its tax burden from $242,000 to approximately $194,000 (0.484% wholesaling tax rate x $40 million of selling activity, with the $40 million of manufacturing activity shifted into Washington enjoying an exemption or *zero* tax rate).

Each of these examples illustrates that by *increasing* business activities in Washington—*i.e.*, reducing interstate commerce—taxpayers can *reduce* their Washington tax burden. Washington's taxes thus discriminate even under the State's definition.

b. **State's Narrow Theory of Discrimination Is Wrong.** The State is wrong in theorizing that only two specific kinds of commercial advantage discriminate against interstate commerce. The State relies upon *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984). *See* Appellee's Br. 16. There, the Court invalidated New York's tax incentive aimed at encouraging more exporting from New York. Washington asserts that "the Court struck down the credit only because it *reduced* the business' New York tax burden, *e.g.*, from $420 to $406, if the business *increased* its percentage of shipping out of New York from zero to one hundred percent. 466 U.S. at 400 n.9 (Table A)." Appellee's Br. 16 (emphasis in original)

Curiously, the State ignored the Court's *explicit negation of that assertion* by failing to note the entirety of the Court's analysis. The Table A example relied on by the State considered only the effect that a shift in export activity had on the DISC credit. That limited picture gave the State the mistaken impression that increasing in-state activity would reduce the New York tax burden. As the Court proceeded to demonstrate in Table B, however, the New York tax burden actually *increased* with greater export activity in that state (when apportionment, as well as the credit, was considered). The Court expressly recognized that, as a result of shifting business activity into New York, "the increased tax liability will more than offset the increased credit, so that the parent's *tax liability* to the State of New York, in absolute terms, *increases.*" *Id.* at 401 n.9 (emphasis supplied).[8] The Court has thus rejected—both by explicit statement and by example—the State's theory that a direct commercial advantage for local business is only objectionable if *increasing* local business *decreases* the tax burden.

2. **State's Concession Reveals Discrimination.** The State has conceded that "*if* the manufacturing tax stood alone it would be discriminatory because it applies primarily to interstate commerce." Appellee's Br. 22. The concession was unavoidable, because Washington's tax on manufacture is imposed only when the goods are *not* sold within the State. As a consequence, the State has been

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[8]As Table B shows, a taxpayer moving all of its export activity into New York to take maximum advantage of the credit would pay a New York tax of $435—obviously a higher burden than the $400 tax absent such a shift.

forced to claim that the tax on manufacture can be saved as a "compensating tax" to the tax on selling—if "the two taxes are considered together." *Id.* at 22-23. That claim depends on assumptions that are plainly wrong.

a. **Equal Burden Assumption Wrong.** The State asserts "Washington's manufacturing tax meets the compensating tax criteria" because the selling and manufacturing taxes "are designed to tax equally all goods sold or manufactured in Washington." *Id.* at 28. We are told that "the end result of these statutes is that all products sold or manufactured in Washington are subject to one B&O tax, either selling or manufacturing." *Id.* at 3-4. This one-tax-per-product premise is demonstrably wrong:

(i) *Three tax burdens vs. one.* Washington's tax generally operates as a pyramiding tax. For example: Extractor A sells its extracted product to Manufacturer B, who manufactures and sells it to Retailer C, who sells to the consumer, all within Washington. *Each* of the three businesses is taxed, so the product is burdened with *three* B&O taxes.[9] By contrast, if a single business performed all three activities within the state, there would be only one tax burden on the product (imposed on the retailing activity).[10]

(ii) *Two taxes on interstate commerce vs. one on local business.* Company X extracts a product in Washington, manufactures the product in Oregon, and returns

[9]See Wash. Rev. Code §§ 82.04.230, 82.04.240, 82.04.250 & 82.04.440.

[10]Wash. Rev. Code § 82.04.440.

it for sale in Washington. X pays two Washington taxes, a tax on its extraction activity and a tax on its selling activity.[11] The same two-tax result occurs where Company Y partially manufactures a product in Washington, completes the manufacture in Oregon, and returns the product for sale in Washington. Y pays two Washington taxes, one on its in-state manufacturing and one on its selling activities.[12] Competitors of X and Y, performing the same activities within Washington, would pay only one tax.

The premise of the State's compensatory argument—that it seeks "equality" via a one-tax-per-product scheme—is clearly wrong.

(iii) *Inequality of Rates.* The State's "equality" argument depends explicitly on its assertion that it taxes manufacturing and selling at "identical" rates. *See* Appellee's Br. 11, 28-29. That assertion is wrong. The rate for manufacturing is sometimes higher, sometimes lower, and sometimes equal to the rate for selling.[13]

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[11]*See* Wash. Rev. Code §§ 82.04.230, 82.04.270 & 82.04.440.

[12]*See* Wash. Rev. Code §§ 82.04.240, 82.04.270 & 82.04.440; *see also Fibreboard Paper Products Corp. v. State,* 66 Wash. 2d 87, 401 P.2d 623 (1965).

[13]A few examples will suffice to illustrate the error of the State's "identical rate" characterization:

(a) The rate for manufacturing wheat (.330%) is many times *higher* than the rate on wholesaling wheat (.011%). *See* Wash. Rev. Code §§ 82.04.260(2), (1) & 82.04.2904.

(Continued on following page)

b. **Unlike Consumption Taxes, Taxes Here Not on Equivalent Events.** Even if Washington burdened manufacturing and selling equally, its taxes are not "compensatory" because manufacturing and selling are not substantially equivalent events. *Armco, Inc. v. Hardesty,* 467 U.S. 638 (1984).[14] The State's attempt to avoid the *Armco* holding is grounded on a confusion of its business and occupa-

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(Continued from previous page)

(b) The rate for manufacturing seafood (.138%) is much *lower* than the rate on wholesaling seafood (.484%). *See* Wash. Rev. Code §§ 82.04.260(4), 82.04.270(1) & 82.04.2904.

(c) Most other manufacturing is taxed at a rate (.484%) *higher* than that on retailing the same products (.471%). *See* Wash. Rev. Code §§ 82.04.240, 82.04.2904, 82.04.250, 82.04.2901 & 82.02.030. (Before 1983, the rates imposed under Wash. Rev. Code §§ 82.04.240 and 82.04.250 were equal.)

For many types of goods, Washington taxes manufacturing and wholesaling at the same rates. However, this leaves the Court with the same problem it identified in *Armco, Inc. v. Hardesty,* 467 U.S. 638 (1984), when West Virginia claimed that *its* manufacturing and wholesaling taxes were "compensating": one cannot tell what portion (if any) of Washington's wholesaling tax is attributable to manufacturing and what portion to selling. *Id.* at 643. Nor can Washington's taxes be justified (when rates are equal) by the economic analysis of the *Armco* dissent, based on the *differential* between the .88% tax on local business and the .27% tax on interstate commerce. *Id.* at 647.

[14]*See also Walling v. Michigan,* 116 U.S. 446 (1886) (taxes imposed solely on interstate sellers of liquor struck down as discriminatory, despite similar tax on in-state manufacturers of liquor), *cited with approval, Bacchus Imports, Ltd. v. Dias,* 468 U.S. 293, 271 (1984). *See also* W. Hellerstein, Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination, 39 Tax Lawyer 405, 450 (1986) (concurring in *Armco's* conclusion that taxes on manufacturing and selling are not complementary, based on a different analysis).

tion taxes with local consumption taxes.[15] Appellee's Br. 25-28. The Court has allowed the state of consumption to tax interstate sales to local consumers by means of the sales or use tax.[16] Sales and use taxes, both being imposed on consumption, are recognized as "compensating taxes" applied to "substantially equivalent events." *Maryland v. Louisiana*, 451 U.S. 725, 758-59 (1981). Sales and use taxes are intended to assure a uniform tax burden on goods consumed in the taxing state. *Id.* at 759. The State has erroneously portrayed its taxes on manufacturing and selling as having the same result as consumption taxes—imposing *one*

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[15]As an *amicus* in *Armco,* Washington made the same compensatory argument, based on the same authority, it does here. The State persists in citing *Hinson v. Lott,* 75 U.S. (8 Wall.) 148 (1869), as if it involved taxes on manufacturing and selling (*see* Appellee's Br. at 27)—a mistaken impression the State admitted it could not reconcile with the Court's later decision in *Walling v. Michigan,* note 14 *supra. See* Brief of the State of Washington as *Amicus Curiae, Armco,* at 6-7. Whereas *Walling, Armco* and the present appeal involve taxes on manufacturing and on selling, *Hinson* involved a tax on a particular kind of property ("spirituous liquors") that was collected from either the importer or distiller. 75 U.S. at 152-53. The tax upheld in *Hinson* "was only the complementary provision necessary to make the tax equal on all liquor sold in the state." *Id.* at 153; *see also* 1865 Ala. Acts §§ 11-15.

[16]Special Subcomm. on State Taxation of the House Comm. on the Judiciary, *State Taxation of Interstate Commerce,* H.R. Rep. No. 565, 89th Cong., 1st Sess. at 1037-47 (1965) (and cases cited therein).

tax burden on the product.[17] The fallacy of the State's characterization has already been demonstrated.[18]

Moreover, the State's attempted analogy to consumption taxes refers to taxes imposed on *local* consumers—for whom Washington could assert a sovereign interest in equalizing tax burdens. In contrast, Washington's tax on manufacturing generally falls on ***consumers in other states.*** The State admits that it "applies primarily to interstate commerce"[19]—*i.e.,* to manufacturers who sell across state lines instead of locally. Therefore, Washington's defense of the manufacturing tax as compensatory to its tax on *local* selling—allegedly because the two taxes "are designed to tax equally all goods sold or manufactured in Washington"[20]—is an attempt to equalize burdens on *local* consumers with burdens on ***consumers in other states.***

This Court has rejected that kind of "equalizing." *See Maryland v. Louisiana, supra.* Like Washington's manufacturing tax, the Louisiana First-Use Tax was designed to fall primarily on consumers in other states. 451 U.S. at

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[17]Appellee's Br. 3-4, 19-20. The error of the State's portrayal is explained in J. Hellerstein & W. Hellerstein, State & Local Taxation 301-03 (4th ed. 1978).

[18]*See* paragraph 2a *supra*. *See* also Wash. Rev. Code § 82.04.500 ("It is not the intention of this chapter that the taxes herein levied upon persons engaging in business be construed as taxes upon the purchasers or customers"); Wash. Rev. Code § 82.04.220 (B&O taxes are "for the act or privilege of engaging in business activities"); and *Fibreboard Paper Products Corp. v. State,* 66 Wash. 2d 87, 90, 401 P.2d 623, 625 (1965) (it "is the activity of manufacturing, not the product, which gets taxed").

[19]Appellee's Br. 22.

[20]*Id.* at 22, 28-29.

758-59. It was defended as compensatory to Louisiana's tax on severance of gas from within the state. While acknowledging that the First-Use Tax "does equalize the tax burdens on OCS gas leaving the State and Louisiana gas going into the interstate market," the Court held that "this sort of equalization is not the kind of 'compensating' effect that our cases have recognized." *Id.* at 759. Just as Louisiana had no legitimate interest in equalizing burdens borne by consumers in other states, neither does Washington. The Court explained:

> The two events are not comparable in the same fashion as a use tax complements a sales tax. In that case, a State is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials to be *consumed in the State.*

451 U.S. at 759 (emphasis supplied), followed in *Armco,* 467 U.S. at 643, holding explicitly that manufacturing and selling taxes are not imposed on substantially equivalent events. The force of that holding is equally applicable here.

3. **Considering Manufacturing and Selling Taxes Together Requires Internal Consistency.** The State's admission that its manufacturing tax discriminates unless "considered together" with the selling tax (Appellee's Br. 22-23) demonstrates the very discrimination the State denies. Considering the two taxes (on manufacturing and selling) together was precisely what this Court did in *Armco.* Observing that "when the two taxes are considered together, discrimination against interstate commerce persists," this Court explained that if other states imposed a like tax—which they have every right to do—interstate commerce will pay both a manufacturing and wholesaling tax, while local business will pay only one tax. 467 U.S. at 644. (The *Armco* opinion subsequently termed that analysis a require-

ment of "internal consistency." *Id.*) The State, finding it necessary to ask that the taxation of manufacturing and selling be "considered together," thus brings into play the internal consistency requirement,[21] which it admits that its taxes cannot meet. Brief of State of Washington as Amicus Curiae at 18, *Armco, supra; see also* State's Executive Briefing Chart, App. K to J.S. (devised by the State to depict its *Armco* problem); and Appellee's Br. 31-32.

The State's brief invites this Court's attention to its 1985 amendment of the tax scheme, which the State says was adopted to deal with its internal consistency problem. *See* Appellee's Br. 46-47. The amendment was not addressed by the court below because it found the tax constitutional without aid of corrective legislation. App. to J.S. at A-1. This Court might consider the amendment ripe for consideration because—according to the State—it bears on the internal consistency of the tax and applies retroactively to the tax years in issue here. *See* Wash. Rev. Code § 82.04.440, as amended in 1985; Appellee's Br. App. A-1.

The device employed by the amendment is an ostensible credit against Washington's manufacturing tax for selling taxes paid on the same goods to other states—*restricted,*

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[21]The State's dependence also refutes its claim that *Armco's* internal consistency analysis was mere *dicta*. Appellee's Br. 30. According to the State's "compensating tax" argument, the Court's consideration of the manufacturing and selling taxes together is *essential* to a correct analysis of the discrimination issue—and cannot, therefore, be merely *dicta*.

however, to situations where other states impose a gross receipts tax like Washington's.[22] According to *amici* National Governors' Association, *et al.* (Br. at 2), Washington is now the only state imposing such a tax. The "credit" is thus illusory. In any case, it fails to cure the discrimination inherent in Washington's statutes because it does not accord interstate commerce equal treatment with that given local business. Washington *guarantees* local business a *100% exemption* from the manufacturing tax if it performs its manufacturing and selling activities entirely within the state. By contrast, the "credit" for Washington manufacturers selling in interstate commerce is not guaranteed, but only a conditional possibility, and may well be less than 100% (if, indeed, there is any credit at all). Out-of-state manufacturers selling into Washington and paying Washington's tax on selling are not even offered a conditional credit to serve in lieu of the exemption granted to local business only. Besides failing to eliminate the facial discrimination of Washington's taxes, the amendment does nothing to correct their lack of fair apportionment.

The amendment also discriminates against interstate commerce on its face even if it were really possible to qualify for a credit. By its terms the credit is the exclu-

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[22]The legislature did not consider its business and occupation taxes similar enough to sales and use taxes to permit a credit when Washington's manufacturing tax is being imposed on goods that are subject to other states' sales or use taxes. This conclusion is directly contrary to the assertion that Washington's "gross receipts tax is a kind of sales tax." *See* Brief of the National Governors' Association, *et al.*, as *Amicus Curiae* in Support of Appellee at 2.

sive relief where a court has "determined . . . an unconstitutional discrimination against interstate or foreign commerce." Appellee's Br. App. A-1. Taxpayers entitled to to tax refunds on other grounds, including other state or federal constitutional grounds, are not affected. They continue to be covered by Washington's general statutes affording full refund of invalid or erroneous taxes. Wash. Rev. Code §§ 82.04.4286, 82.32.060 & 82.32.180. Under Washington's amended scheme, victims of discrimination against interstate commerce are treated as a disfavored, special class and denied the refund relief that is available to all other taxpayers. If legislatures practicing discrimination against interstate commerce could so easily retain the fruits of their discrimination, the Commerce Clause would indeed be ineffectual.

4. **Taxes "Considered Together" Contradicts State's Apportionment Contention.** The State has misunderstood National Can's apportionment argument. *See* Appellee's Br. 33. There is no claim that Washington taxes all National Can's income from all sources. Rather, the vice of the tax is that it reaches 100% of all gross receipts with which Washington has a nexus—even though those receipts were produced in part by activities performed in other states. *See* J.A. 175, ¶ 4; 179, ¶¶4-5; 180, ¶¶ 7-8.

The State, returning to a formalism from earlier days, asserts that "Selling and manufacturing are both *local* privileges. . . ." Appellee's Br. at 34 (emphasis supplied). Observing that states providing the market have been permitted to tax interstate sales to the exclusion of origin states, Washington concludes that it is the only state that can tax the "local" privilege of interstate sell-

ing. On the other hand, when Washington is the situs of the extracting or manufacturing part of the interstate business, Washington concludes that it is the only state that can tax these "local" activities as well. But when the taxes on both activities are considered together (as Washington insists in attempting to save them from discrimination), it is apparent that Washington is taxing *both* ends of the interstate business—contradicting the claim it makes at each end that only one state can tax the business.

Washington's tax at each end is measured by the *entire gross receipts* from the interstate activities—*i.e.*, the activities conducted in other states, as well as those in Washington. The State pretends that the business which manufactures in Washington and sells in other states has derived 100% of its receipts from the *manufacture alone*—while simultaneously pretending that the business which sells in Washington goods that it has manufactured in other states has derived 100% of its receipts from the *selling alone*. The problem of multiple taxation created by Washington's taxes cannot be meaningfully distinguished from the problem as to other privilege and income taxes where apportionment has been required.[23] If Washington can tax both ends of an interstate business, so can

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[23]Compare the present situation with the Court's explanation of the circumstances in which apportionment is required. *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123, 132-35 (1931); *see also Gwin, White & Prince, Inc. v. Henneford,* 305 U.S. 434 (1939) (requiring apportionment in the context of Washington's business and occupation tax, there imposed on a fruit broker); and *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 275, 279 (1977) (confirming requirement of fair apportionment in context of business privilege tax measured by gross receipts).

any other state having comparable contacts. Where 100% of the income produced by both ends of the interstate activity is taxed by one state without apportionment, multiple taxation is inevitable.

5. **Actual Multiple Tax Burdens.** The resulting actual burden is confirmed by the stipulated record here. Washington imposes on National Can an unapportioned manufacturing tax, *i.e.,* a tax measured by 100% of National Can's receipts from sales in other states of products manufactured in Washington. Wash. Rev. Code § 82.04.240. Those other states also tax National Can's activity, but on an *apportioned* basis, measured by the same receipts. J.A. 181-82, ¶ 15.

Similarly, National Can pays Washington an unapportioned selling tax measured by 100% of National Can's receipts from products it manufactures in other states and sells in Washington. Wash. Rev. Code § 82.04.270(1). Those other states impose apportioned taxes on the same income. J.A. 182, ¶ 15.

Washington's unapportioned taxes therefore cause National Can to be subjected to an unconstitutional actual multiple tax burden.

6. **State's Prospective Application Request Premature.** Anticipating the possibility of an adverse decision, the State asks the Court either to limit its decision to

prospective application or to refrain from addressing the issue of remedy. *See* Appellee's Br. 44-48. The State's petitions are premature.[24] Moreover, to deny the recovery of taxes collected in violation of the Constitution would deny these Appellants its protection and undermine the purposes of the Commerce Clause.[25]

CONCLUSION

For the foregoing reasons and those set forth in Appellants' main brief, the decision below should be reversed.

Dated: February 6, 1987.

Respectfully submitted,

JOHN T. PIPER*
D. MICHAEL YOUNG
FRANKLIN G. DINCES

BOGLE & GATES
2000 Bank of California Center
Seattle, Washington 98164
(206) 682-5151

Counsel for Appellants

*Counsel of Record

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[24]The State has confirmed prematurity by blocking consideration of sealed Exhibit 32, which must be unsealed and made available to counsel for argument when "prospective application" becomes ripe. *See* J.A. 172.

[25]Permitting states to retain the fruits of their discrimination would encourage them to adopt schemes shifting tax burdens from local to interstate commerce, and to resist correction as long as possible. The Court has held that "a denial by a state court of recovery of taxes enacted in violation of the laws or Constitution of the United States by compulsion is itself in contravention of the 14th Amendment." *Carpenter v. Shaw*, 280 U.S. 363, 369 (1930). *See also Ward v. Love County*, 253 U.S. 17, 24 (1920) ("to say that the county could collect these unlawful taxes by coercive means, and not incur any obligation to pay them back, is nothing short of saying that it could take . . . property . . . arbitrarily and without due process of law").